

ANALYSIS OF ORIGINAL BILL

Author: Hurt Analyst: Roger Lackey Bill Number: SB 1994

Related Bills: See Legislative History Telephone: 845-3627 Introduced Date: 02-20-98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Net Operating Loss Conformity

SUMMARY

This bill would conform the California Revenue and Taxation Code to the federal Internal Revenue Code in regard to the treatment of net operating losses (NOLs).

EFFECTIVE DATE

This bill would be effective for taxable or income years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

AB 3699, SB 45 (93/94)

SPECIFIC FINDINGS

State law conforms, with certain modifications, to the federal NOL provisions. Generally, an NOL occurs when the taxpayer's business expenses exceed income. For **federal** purposes, an NOL can be carried back to each of the two preceding years and carried forward to each of the 20 following years. **California** modifies the federal NOL rules to prohibit carryback of the NOL deduction and to generally specify that only 50% of the NOL can be carried forward as a deduction, and generally that carryover is for five years.

State law contains special NOL provisions for the first three years a taxpayer operates a "new business." These taxpayers are allowed to carry forward 100% of the NOL that is equal to the net loss incurred in each of the first three years of the new business. For that portion of the NOL that exceeds the net loss, 50% of that amount is carried forward as a NOL to future years. The NOL from the first year of business may be carried forward eight years, the NOL from the second year may be carried forward seven years, and the NOL from the third year may be carried forward six years. All net operating losses incurred after the first three years of business are no longer treated as a "new business" NOL and can only be carried forward five years at 50% of the total loss.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___ X ___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director Date
Gerald H. Goldberg 3/23/98

Agency Secretary Date

By: Date

Also, **state law** contains special NOL provisions for a taxpayer that operates an "eligible small business." An eligible small business is defined as any trade or business that has gross receipts, less returns and allowances, of less than \$1 million during the taxable year. These taxpayers are allowed to carry forward to each of the five taxable years following the year of the loss, 100% of the eligible small business NOL, up to the amount of the taxpayer's total net loss incurred for the taxable year of the loss. For that portion of the taxpayer's total net loss that exceeds the eligible small business loss, 50% of that amount is carried forward as a NOL to future years.

Existing state law also contains special NOL provisions for qualified taxpayers who operate businesses within an enterprise zone, the Los Angeles Revitalization Zone (LARZ), a local agency military base recovery area (LAMBRA), or a targeted tax area (TTA). These qualified taxpayers are allowed to carry forward 100% of their NOL for 15 taxable or income years but may only use those carryovers to offset income produced in the area or zone.

California law allows special carry forward treatment for losses incurred as result of a disaster declared by the President. That is, 100% of the excess disaster loss may be carried over for up to five taxable years, and if any of the excess loss remains after the five-year period, 50% of the remaining excess loss may be carried over for up to 10 additional years.

In the case of corporations doing business both within and without this state, California, as do most states, taxes corporations exclusively on a source basis, with source income being determined by use of an apportionment formula. While a state cannot tax income from sources outside the state, it is similarly not obligated to consider losses from sources outside the state. Thus, the applicable apportionment rule governing NOLs (Section 25108) provides that a taxpayer has a California NOL based on the sum (or net) of its California-apportioned income (or loss) and its allocated income (or loss).

This bill would repeal all current special California NOL provisions (other than the rules relating to apportioning taxpayers). Taxpayers would carry forward any existing unused NOL according to the laws in existence prior to enactment of this bill, as provided for by the federal Taxpayer Relief Act of 1997.

This bill would conform the personal income tax law (PITL) and the bank and corporation tax law (B&CTL) to the federal NOL provisions. Specifically, this bill would allow all taxpayers to carry back 100% of the NOL to each of the two taxable or income years preceding the taxable year of the loss and carry forward 100% of the remaining NOL to each of the 20 taxable or income years following the year of the loss.

This bill specifies that it applies only to the computation of taxes for years beginning on or after January 1, 1998.

Policy Considerations

Enterprise zones and the LARZ were primarily created to encourage development in economically disadvantaged areas. By eliminating the special more favorable NOL provisions for these areas and substituting rules which place all taxpayers on an equal footing with respect to the treatment of

NOLs, this bill eliminates one incentive for businesses to locate in these depressed areas.

Implementation Considerations

In future years it would be expected that the department would receive an increased number of amended tax returns due to the carryback of NOLs. However, it is the department's understanding that the author's intent is to amend the bill to not allow carrybacks. Therefore, implementing this bill would not otherwise significantly impact the department's programs and operations.

Technical Considerations

This bill would apply to the computation of taxes only for taxable and income years beginning on or after January 1, 1998. It is unclear if this bill would allow existing NOLs to extend the carry forward to 20 years as provided by the IRC or would remain at five years as provided by current California law. It is the department's understanding that the author's intent is for the carry forward period for existing NOLs to remain at five years, therefore, it is suggested that Amendment 1 and 2 be included in the language of the bill.

Current law Section 25108(b) contains references to both Sections 24416.1 and 24416.2, both of which would be repealed by this bill. As a result, Section 25108(b) should be amended to strike these two cross-references.

FISCAL IMPACT

Departmental Costs

This bill would not significantly impact the department's costs

Tax Revenue Estimate

Revenue losses from this bill are estimated to be:

Beginning on or after January 1, 1998 Assumed Enactment After June 30, 1998 (millions)					
	1998-9	1999-0	2000-1	2001-2	2002-3
Bank & Corporation Tax	(\$2)	(\$136)	(\$268)	(\$323)	(\$345)
Personal Income Tax	-	(\$27)	(\$54)	(\$65)	(\$69)
Total Impact	(\$2)	(\$163)	(\$322)	(\$388)	(\$414)

This analysis assumes that the intent is to allow carrybacks to 1998 and subsequent years with losses occurring for years beginning after 1998 and first allow 100% carryforward with operating losses occurring in 1998. Possible changes in employment, personal income, or gross state product that could result from this measure are not considered.

Revenue Discussion

Revenue losses under the Personal Income and Bank & Corporation Tax laws depend on the amount of positive adjusted gross/state net income that is available for deducting operating losses retroactively (up to two years) and prospectively.

Estimates are based on actual NOL deductions claimed for the 1996 taxable/income year, adjusted to reflect 100% NOL carrybacks/carryovers for operating losses occurring in years explained above. These estimates allow for the limited availability of 100% NOL deductions under current law.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1994
As Introduced February 20, 1998

AMENDMENT 1

On page 8, line 28 after "17276.", insert:

(a)

AMENDMENT 2

On page 8, between lines 30 and 31, insert"

(b) This act is effective for NOLs arising in taxable years beginning on or after January 1, 1998. The act does not apply to NOLs carried forward from prior taxable years."